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No. 89-1965

Supreme Court, U.S.
FILED
NOV 15 1990
JOSEPH P. SPATOL, JR.
CLERK

In The  
**Supreme Court of the United States**  
October Term, 1990

COTTAGE SAVINGS ASSOCIATION,  
*Petitioner,*  
v.

COMMISSIONER OF INTERNAL REVENUE,  
*Respondent.*

On Writ Of Certiorari To The  
United States Court Of Appeals For The  
Sixth Circuit

**BRIEF FOR PETITIONER**

DENNIS L. MANES\*  
SCOTT M. SLOVIN  
SCHWARTZ, MANES & RUBY  
2900 Carew Tower  
411 Vine Street  
Cincinnati, Ohio 45202  
(513) 579-1414

ATTORNEYS FOR PETITIONER  
COTTAGE SAVINGS  
ASSOCIATION

\*Counsel of Record

730P2

**QUESTION PRESENTED FOR REVIEW**

- I. Whether a savings institution, having incurred real economic losses on residential mortgages it holds, realizes and recognizes a deductible loss for income tax purposes when it exchanges its mortgages for mortgages of another savings institution that (i) have different obligors, (ii) are secured by different real properties, and (iii) perform differently in terms of actual payments received.

### RULE 29.1 STATEMENT

Pursuant to Rule 29.1 of the Rules of this Court, Petitioner, Cottage Savings Association, states that Tri-State Bancorp is its parent company and that it has no subsidiaries other than wholly owned subsidiaries.

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BRIEF FOR PETITIONER

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Sixth Circuit (P.A. 1a)<sup>1</sup> is reported at 890 F.2d 848. The opinion of the United States Tax Court (P.A. 16a) is reported at 90 T.C. 372.

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<sup>1</sup> References to P.A. refer to the Appendix in the Petition for a Writ of Certiorari in this case. The filing of a Joint Appendix was dispensed with pursuant to a motion filed by Petitioner on October 25, 1990 and granted on November 5, 1990.

## JURISDICTION

The judgment of the United States Court of Appeals for the Sixth Circuit was entered on December 4, 1989. A Petition for Rehearing was timely filed by the Petitioner on December 29, 1989. The Petition for Rehearing was denied on March 14, 1990. The Petition for Writ of Certiorari was filed on June 11, 1990. This Court granted the Petition on October 1, 1990. The Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

## RELEVANT STATUTORY PROVISIONS

The following sections of the Internal Revenue Code of 1954 (26 U.S.C.) and Treasury Regulations on Income Tax (26 C.F.R.), sections of prior revenue acts and Treasury Regulations as well as Memorandum R-49 are set out verbatim in the Appendix or in the Petition for Writ of Certiorari as follows:

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## STATEMENT OF THE CASE

Cottage Savings Association (hereinafter referred to as "Cottage") is a federally insured savings and loan institution subject to the regulations of the Federal Home Loan Bank Board (hereinafter sometimes referred to as the "FHLBB"). (P.A. 18a). On December 31, 1980, Cottage exchanged some of its mortgage loans for mortgage loans owned by four unrelated savings and loan institutions located in the Cincinnati and Portsmouth, Ohio areas. (P.A. 24a, 25a). Cottage's loan portfolio in general and the specific mortgage loans exchanged had declined in value because of economic conditions general to the savings and loan industry and because of increases in mortgage interest rates. (P.A. 25a, 31a). As a result of these transactions, Cottage deducted losses on its tax return for 1980, carried back said losses to earlier years (1974 through 1979), and recovered federal income taxes it had previously paid.

The Internal Revenue Service (sometimes hereinafter referred to as the "Government"), disagreeing with Cottage's tax treatment of this transaction (hereinafter sometimes referred to as "reciprocal mortgage loan transactions" or "reciprocal sales"), issued a statutory notice of deficiency to Cottage on June 24, 1983, disallowing the deductions. Cottage filed a petition in the United States Tax Court on September 23, 1983. A trial was held on June 18, 19 and 20, 1985 in Cincinnati.

On March 14, 1988, the Tax Court issued its opinion, reviewed by the entire court (two judges did not participate), holding for Cottage and sustaining Cottage's loss on its reciprocal mortgage loan transactions. (P.A. 16a). The Tax Court held that Cottage realized losses in the years under review and that the losses were recognized and deductible for income tax purposes. A decision was entered by the Tax Court on October 3, 1988.

From that judgment, the Internal Revenue Service took its appeal to the United States Court of Appeals for the Sixth Circuit by Notice of Appeal filed on December 30, 1988. After briefing and argument, the Court of Appeals rendered its opinion (P.A. 1a) and judgment (P.A. 57a) on December 4, 1989, reversing the judgment of the Tax Court.

The Court of Appeals agreed with the Tax Court that, in form, Cottage's reciprocal sales produced an identifiable event that fixed a loss which was both realized and recognized for federal income tax purposes. However, it reversed because it said that no loss was sustained by Cottage under Section 165 of the Internal Revenue Code.<sup>2</sup> A timely Petition for Rehearing was denied on March 14, 1990. (P.A. 58a).

The basic facts in this case are fully set forth in detail in the Sixth Circuit Court of Appeals (P.A. 1a) and Tax Court (P.A. 16a) opinions. As interest rates rose in the late 1970s, savings institutions were caught in a cash squeeze. Money was flowing into higher-yielding money market funds rather than to savings institutions as deposits. Even though their return from loans was low, the market required savings institutions to pay higher and higher interest rates in order to attract new deposits. Earnings declined as interest paid on deposits exceeded the

<sup>2</sup> Section 165 of the Internal Revenue Code provides, in general, that all losses sustained in a taxable year are deductible unless compensated by insurance or otherwise.

interest earned on long-term fixed-rate mortgage loan portfolios. (P.A. 2a, 18a).

Because of the increase in mortgage interest rates, the market values of existing fixed-rate mortgage loan portfolios held by savings institutions, including Cottage, were substantially less than the book values of these portfolios. Even though Cottage began offering adjustable rate mortgages in 1980, it continued to experience a drop in new loans and a drop in deposits. Cottage experienced a shortage of funds because of the loss of deposits to money market mutual funds and because the high interest rates charged by the FHLBB eliminated the FHLBB as a source of funds. Cottage expected this decline in deposits to continue. (P.A. 2a, 18a).

FHLBB regulations required Cottage (and other federally insured savings and loan institutions) to meet certain net worth requirements. If Cottage had merely sold the mortgage loans it transferred, and had been required by the FHLBB's regulatory accounting principles (sometimes hereinafter referred to as "RAP") to reduce its net worth by the amount of losses it would have sustained on such a sale, Cottage's net worth would have been reduced to a level that barely exceeded the FHLBB's minimum requirement. (P.A. 19a).

To relieve this dilemma, on June 27, 1980, the Director of the Office of Examination and Supervision ("OES") of the FHLBB promulgated a change in its accounting requirements known as "Memorandum R-49" ("R-49").<sup>3</sup> Under R-49, institutions were no longer required to record such losses from the sale (and purchase) of mortgage loans on their books. By observing R-49's criteria, savings institutions including Cottage attempted to generate federal income tax refunds by entering into reciprocal sales transactions that produced deductible losses

<sup>3</sup> Federal Home Loan Bank Bd. Mem. No. R-49 (June 27, 1980). The entire text of Memorandum R-49 is set forth in the Appendix to the Petition for Writ of Certiorari. (P.A. 59a).

without impairing their net worth. (P.A. 2a). R-49 lists ten criteria, all of which must be satisfied, for mortgage loans involved in reciprocal sales to be considered "substantially identical" for regulatory accounting principles. (P.A. 3a). Memorandum R-49 was the FHLBB's response to a desire of the savings and loan industry to structure exchanges of mortgage loans to create losses for income tax purposes which would not be reported for RAP or under generally accepted accounting principles. (P.A. 20a). All of the mortgage loans involved in Cottage's reciprocal sales satisfied the R-49 requirements. (P.A. 3a, 30a).

The ten criteria selected in R-49 represented an attempt by the FHLBB, OES to maintain the institution's position with respect to three types of risk in a loan portfolio: (1) credit (or collectability), (2) rate (or future earnings potential), and (3) repayment (or extent of principal repayments and prepayments). It was the OES' opinion that a change in any of these risks would change the economic factors underlying an institution's loan portfolio and require recording of the resulting gain or loss under RAP. (P.A. 21a). According to the OES, these ten criteria vary in importance and effect and all are necessary to structure a transaction that does not trigger a loss for accounting purposes. (P.A. 22a).

In October of 1980, Cottage's accountant attended a seminar where he was introduced to the concept of reciprocal loan sales. On November 6, 1980, Cottage's accounting firm gave a similar seminar for financial institutions, which was attended by Cottage's President. On November 10, 1980, Cottage's accountants discussed reciprocal sale transactions with Cottage's Board of Directors, and on that date the Board passed a resolution to enter into such a transaction. (P.A. 23a).

In accordance with the requirements of R-49, on December 31, 1980, Cottage entered into a series of Loan Participation Sale and Trust Agreements with four other unrelated savings institutions (three located in Cincinnati and one in Portsmouth, Ohio). In each transaction, checks

were paid to and from Cottage and its trading partners for the current fair market value of the mortgage loans (computed using an interest rate at December 31, 1980 of 14.863 percent). The transactions resulted in Cottage selling ninety percent mortgage participation interests in 252 of its mortgage loans and purchasing ninety percent mortgage participations in 305 different loans from its trading partners. (P.A. 3a, 24a, 27a).

The participations sold and bought by Cottage all were in loans that had different obligors, were "conventional" loans secured by mortgages on single-family residences, and were current. The underlying security (real estate) for each loan was different. Most of the properties were inside the Cincinnati "beltway". Some of the properties where Cottage was the buyer were as far north as Dayton, Ohio (about 55 miles from Cincinnati) and some were as far east as Jackson, Ohio (about 120 miles from Cincinnati). Of the properties where Cottage was the seller, some were as far north as Middletown, Ohio (about 35 miles from Cincinnati), and some were as far east as Batavia, Ohio (about 25 miles from Cincinnati). (P.A. 28a).

Sales of loan participations (such as the ninety percent participations exchanged in this case) are customary in the savings and loan industry. Cottage made no attempt to determine, prior to the transactions at issue, whether there was a difference between the prepayment potential of the loan participations received by Cottage and those transferred by Cottage. Nevertheless, actual collections received by Cottage did not achieve the equality anticipated at the time of the transfers. The actual payments received by Cottage's trading partners on account of loan participations Cottage sold exceeded the actual payments received by Cottage on participations it purchased by \$191,389 for the period beginning with the date of sale and ending on March 31, 1985. Absent misrepresentations, the party receiving less in actual collections (Cottage) had no recourse against the party receiving more. (P.A. 29a, 30a).

Participation interests are less liquid than whole loans in the secondary market. As a result, after the December 31, 1980 transactions, Cottage and its trading partners were in a less liquid position (except for income tax refunds) than they had been before the transactions. (P.A. 30a).

The December 31, 1980 transactions were between independent parties. The Tax Court held that the transactions were closed and completed; the transactions were bona fide. (P.A. 30a).

### SUMMARY OF THE ARGUMENT

A. Cottage's loss was realized, recognized and allowed as a deduction. Sections 165 and 1001 of the Internal Revenue Code provide the statutory framework for this three-part test.<sup>4</sup>

Section 165 basically provides that all losses sustained in a taxable year are deductible. In a case with virtually identical facts, the Fifth Circuit agreed with the Tax Court's decision in this case that the transaction was closed and completed, changed the flow of economic benefits, and did not lack economic substance. Thus, the transaction is clearly within the requirements of Treas. Reg. § 1.165-1(b) and (d) for deduction of a loss. *San Antonio Savs. Ass'n v. Commissioner*, 887 F.2d 577, 592 (5th Cir. 1989), *aff'g* 55 T.C.M. (CCH) 813 (1988). In a similar case, the District of Columbia Circuit also agreed with this holding. *Federal Nat'l Mortgage Ass'n v. Commissioner*, 896 F.2d 580 (D.C. Cir. 1990), *aff'g* 90 T.C. 405 (1988).

The Sixth Circuit in this case agreed with the Tax Court that Cottage's loss was realized and recognized, but held that the loss was not allowed as a deduction

<sup>4</sup> The "Code" refers to the Internal Revenue Code of 1954 (26 U.S.C.), as amended and in effect during the years in issue. Except as otherwise specifically noted, section references are to the Internal Revenue Code of 1954.

because it was not "sustained" under Section 165. However, the Government's own regulation provides that "a loss is sustained to the extent of the difference between such adjusted basis and the amount realized", and that "gain or loss realized . . . from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained." Treas. Reg. § 1.1001-1(a). (emphasis added).

The Sixth Circuit's decision that Cottage's loss was not sustained under Section 165 was based on two findings: (1) Cottage received, in accordance with R-49's regulatory accounting criteria "substantially identical" mortgages in the exchange, and (2) Cottage did not record the losses on its books. Even if R-49 is relevant, *Hanlin v. Commissioner*, 108 F.2d 429 (3d Cir. 1939), *aff'g* 38 B.T.A. 811 (1938) held that mortgages secured by different underlying property are not "substantially identical" for tax purposes. The fact that Cottage did not record the loss on its books is irrelevant for tax purposes. *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979).

In the principal case relied on by the Sixth Circuit, *Shoenberg v. Commissioner*, 77 F.2d 446 (8th Cir. 1935), *cert. denied*, 296 U.S. 586 (1935), the taxpayer disposed of and reacquired the exact same property, in contrast to this case where Cottage acquired indisputably different properties.

Finally, the Sixth Circuit's approach in this case frustrates the clear intent of Congress by creating a nonstatutory "wash sale" rule even though it is apparent that this transaction falls outside of the statutory wash-sale provision of Section 1091. Congress addressed the issue of reciprocal mortgage loan transactions in the Tax Reform Act of 1986 when it added Section 56(g)(4)(E) of the Internal Revenue Code. This provision treats seventy-five (75%) percent of the losses from these transactions as a tax preference item subject to the alternative minimum tax.

It is well settled that taxpayers are entitled to arrange their affairs to minimize taxes. *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1935), *aff'd* 293 U.S. 465 (1935). Cottage

exchanged its depreciated mortgage loans for completely different loans and merely chose the time it wished to take its loss for tax purposes. Its loss is clearly deductible under Section 165.

B. Cottage's transfer of mortgages resulted in a realized loss regardless of whether the mortgages it received met the "materially different" requirement of Treas. Reg. § 1.1001-1(a), because there is no "materially different" requirement in the statutory language of Section 1001. Further, the legislative history supports the conclusion that Section 1001 is merely computational.

Section 1001(a) is entitled "Computation of Gain or Loss" and Section 1001(b) is entitled "Amount Realized". Sections 1001(a) and (b) had their origins in Section 202 of the Revenue Act of 1924, Pub. L. No. 68-176, 43 Stat. 253. The legislative history of Section 202 demonstrates that the purpose of this section was "to show clearly the method of determining the amount of gain or loss from the sale or other disposition of property". (Emphasis added). See H.R. Rep. No. 179, 68th Cong., 1st Sess. 12 (1924); S. Rep. No. 398, 68th Cong., 1st Sess. 13 (1924).

Section 1001(c) requires (except as otherwise provided by a statutory nonrecognition provision) that the entire amount of all realized gains or losses must be recognized. Congress' intention in enacting the predecessor of Section 1001(c) (Section 203 of the Revenue Act of 1924) was to enact a broadsweeping recognition requirement and then except specific transactions in which it is not desired to tax the gain or allow the loss. S. Rep. No. 398, 68th Cong., 1st Sess. 14 (1924). None of the nonrecognition provisions of the Code apply to the instant case and the Government has not contended otherwise (except to the extent that Section 1001 may be viewed as a nonrecognition provision). (P.A. 34a). Treasury Regulations confirm that the nonrecognition rules are "exceptions from the general rule requiring the recognition of all gains and losses" and these rules "are strictly construed and do not extend beyond the words or the

underlying assumptions and purposes of the exception." Treas. Reg. § 1.1002-1(a) and (b).

Moreover, Congress acted specifically to exclude notes or evidences of indebtedness from the like-kind exchange rule in 1923. Sec. 202(c), Revenue Act of Mar. 4, 1923, Pub. L. No. 67-545, 42 Stat. 1560. Committee reports acknowledge that the result of the like-kind exchange rule is that while profit and loss on some exchanges are not recognized, that "profit or loss is recognized in the case of exchanges of notes or securities, which are essentially like money . . ." H.R. Rep. No. 704, 73d Cong., 2d Sess. 13 (1934). This exclusion continues to exist today in Section 1031(a). Thus, Section 1001(c) acts to require Cottage to realize and recognize its loss.

Treas. Reg. § 45, art. 1563, promulgated in 1920, permitted a loss to be realized on an exchange if property received was "essentially different" from property disposed of. However, the Government eliminated this "essentially-different" language from the regulation after Congress adopted the broadsweeping recognition requirement in 1924. Both the Tax Court in this case (P.A. 38a) and the District Court in *First Federal of Temple* recognized that the Government abandoned this essential-difference requirement. *First Fed. Savs. & Loan Ass'n of Temple v. United States*, 694 F. Supp. 230, 240 n.11 (W.D. Tex. 1988).

Finally, early cases establish that realization of income or loss is triggered by either a disposition of the taxpayer's property for completely different property or by an exchange for a different interest in the same property. *Weiss v. Stearn*, 265 U.S. 242 (1924); *Marr v. United States*, 268 U.S. 536 (1925). The mortgages Cottage received were clearly different from the mortgages it transferred and its loss must be realized under the tax law.

C. Even assuming that Treas. Reg. § 1.1001-1(a) correctly states the law that realization of gain or loss requires that the property exchanged must differ "materially either in kind or extent", Cottage's transaction met

this materially different test and Cottage's loss should be realized. *Hanlin v. Commissioner*, 108 F.2d 429 (3d Cir. 1939), *aff'd* 38 B.T.A. 811 (1938), is relevant because it involved sales and purchases of bonds secured by pools of mortgages and the definition of "substantially identical" for purposes of the wash sale provision of the predecessor of Section 1091. The Third Circuit in *Hanlin* held that bonds secured by different collateral were not substantially identical "by geographic definition." 108 F.2d at 431. The Tax Court in this case found that Cottage's transaction met the materially different standard in the regulation and specifically found that Cottage's position was even stronger than the taxpayer in *Hanlin*. (P.A. 45a).

Moreover, Treas. Reg. § 1.1001-1(a) does not require that properties in an exchange "differ materially for economic purposes" or "differ materially and predictably in economic risk" or that a taxpayer must be "richer or poorer" as the result of the exchange for realization to occur. If it did, no taxpayer would ever realize gain or loss on an arms-length transaction because parties are always in the same economic position immediately before a transaction as immediately after. Thus, Cottage's loss on the exchange of mortgage loans for completely different mortgage loans should be realized and recognized under Section 1001 and allowed as a deduction under Section 165.

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## ARGUMENT

### I. SECTION 165 OF THE CODE DOES NOT PRECLUDE THE DEDUCTION OF THE LOSS REALIZED AND RECOGNIZED BY COTTAGE.

#### A. COTTAGE PROPERLY DEDUCTED ITS LOSS BECAUSE THE LOSS WAS REALIZED, RECOGNIZED AND ALLOWED AS A DEDUCTION UNDER SECTIONS 1001 AND 165 OF THE CODE.

Cottage properly deducted its loss under the provisions of the Internal Revenue Code, because the loss was (1) realized, (2) recognized, and (3) allowed as a deduction. Sections 1001 and 165 provide the statutory framework for this three part test.

The pertinent provisions of Section 1001 (a) through (c) provide as follows:

#### SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

- (a) COMPUTATION OF GAIN OR LOSS – The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.
- (b) AMOUNT REALIZED – The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received . . .
- (c) RECOGNITION OF GAIN OR LOSS – Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

Section 165(a) provides as follows:

## SECTION 165. LOSSES.

- (a) **GENERAL RULE** – There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Even though Section 1001(a) is entitled "Computation of Gain or Loss," it is understood to include the realization requirement. See 2 B. Bittker, *Federal Taxation of Income, Estates and Gifts*, ¶40.2 at 40-4 (1981).

The Tax Court held that Cottage's loss on the reciprocal mortgage sale was realized, recognized and allowed as a deduction under Section 165. (P.A. 52a). The Sixth Circuit agreed that Cottage realized and recognized its losses, but reversed the decision of the Tax Court because it said the losses were not "sustained" and thus not allowable under Section 165. (P.A. 10a, 14a). The Fifth Circuit, in a reciprocal mortgage sale case with essentially identical facts, agreed with the Tax Court decision in this case and held that the loss was realized, recognized and allowed as a deduction.<sup>5</sup> The District of Columbia Circuit, on the same issue and on similar facts, agreed with the Tax Court in this case and with the Fifth Circuit that a

<sup>5</sup> *San Antonio Savs. Ass'n v. Commissioner*, 887 F.2d 577 (5th Cir. 1989), *aff'g* 55 T.C.M. (CCH) 813 (1988). The facts in *San Antonio* are virtually identical to this case as *San Antonio* was decided by the Tax Court on summary judgment based on an assumption that the facts were essentially the same as in this case. Two other reciprocal mortgage sale cases with similar facts were also decided in the same manner by the Fifth Circuit Court of Appeals. *Centennial Savs. Bank FSB v. United States*, 887 F.2d 595 (5th Cir. 1989), *aff'g in part and rev'g in part*, 682 F. Supp. 1389 (N.D. Tex. 1988), *cert. granted*, 59 U.S.L.W. 3243 (U.S. Oct. 1, 1990) (No. 89-1926), and *First Fed. Savs. & Loan Ass'n of Temple v. United States*, 887 F.2d 593 (5th Cir. 1989), *aff'g* 694 F. Supp. 230 (W.D. Tex. 1988). *Centennial* will be argued in tandem with this case.

loss from a reciprocal mortgage sale transaction is deductible.<sup>6</sup>

## B. ALL REALIZED LOSSES FROM SALES OR EXCHANGES OF PROPERTY ARE "SUSTAINED" UNDER SECTION 165.

All realized losses from sales or exchanges of property are "sustained" under Section 165. Treas. Reg. § 1.1001-1(a). While the Sixth Circuit concluded that Cottage "realized" losses on the exchanges of its mortgages, and that those losses must be "recognized," it held that they were not deductible under Section 165 because they were not "sustained." This interpretation of the tax law is not only squarely contradicted by Treas. Reg. § 1.1001-1(a), it has been rejected by every other court that has considered mortgage exchange transactions.<sup>7</sup>

Treas. Reg. § 1.1001-1(a) explicitly states that if a taxpayer's amount realized from a sale or exchange is less than his adjusted basis in the property, "a loss is sustained to the extent of the difference between such adjusted basis and the amount realized." (Emphasis added.) In addition, the Regulation states that "gain or loss realized . . . from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained." (Emphasis added). Treas. Reg. § 1.1001-1(a). Thus, according to the Regulation, as long as the property exchanged is materially different, then every "realized" loss is "sustained".<sup>8</sup>

<sup>6</sup> *Federal Nat'l Mortgage Ass'n v. Commissioner*, 896 F.2d 580 (D.C. Cir. 1990), *aff'g* 90 T.C. 405 (1988). In fact, the District of Columbia Circuit in *Federal National Mortgage Association* rejected "the Sixth Circuit's reasoning and result in favor of the more persuasive analysis of the Fifth Circuit and the Tax Court . . ." 896 F.2d at 584.

<sup>7</sup> See, e.g., the cases set forth in Notes 5 and 6, *supra*.

<sup>8</sup> Judge Cohen, in her concurring opinion in the Tax Court, held that the property exchanged by Petitioner did not have to

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Every judge in the Tax Court who addressed the issue held that the mortgage loans in this case were materially different. (P.A. 40a). The Tax Court (in contrast with the decision of the Sixth Circuit) correctly held that Cottage's loss was sustained and deductible under Section 165. (P.A. 52a). Nothing in Section 165 or the regulations thereunder is contrary to this conclusion.

### C. THE SIXTH CIRCUIT'S TEST FOR WHEN A LOSS IS SUSTAINED IS CONTRARY TO PRECEDENT.

The Sixth Circuit held that no losses were sustained based on two findings: Cottage (1) received "substantially identical" mortgages in the exchange, and (2) did not record the losses on its books (*i.e.*, for nontax regulatory accounting purposes). (P.A. 14a). Both findings are unfounded and contrary to established authority.

With regard to its first finding, the Sixth Circuit apparently based its finding that Cottage received "substantially identical" mortgages in the exchange on the fact that Cottage complied with the requirements of R-49 so that its mortgages were "substantially identical" for regulatory accounting purposes.

However, that Cottage met the criteria of R-49 only proves that the mortgages received by Cottage were of a similar general nature to those that it transferred in the reciprocal mortgage transaction.<sup>9</sup> In fact, the stated purpose of the ten criteria set forth in Memorandum R-49

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be materially different in order to sustain a loss (P.A. 54a) and the Sixth Circuit seems to agree with Judge Cohen. (P.A. 9a). As discussed *infra* at p. 26, Cottage's position is that there is no "materially different" requirement.

<sup>9</sup> The ten criteria of Memorandum R-49 themselves prove only that the mortgages exchanged are similar. In fact, four of the criteria (2, 5, 8, and 9) use the word "similar." (P.A. 3a, 19a, 20a).

was that the "criteria represented our *attempt* to maintain the association's position with respect to three types of risks in a loan portfolio".<sup>10</sup> (Emphasis added). It is not relevant with respect to the tax law whether property received in an exchange presents the same or different risks with respect to the property transferred.

In addition, the opportunity for savings and loan associations not to report a loss from the reciprocal loan transactions which met the criteria of R-49 was *optional*, not compulsory. Thus, even if Memorandum R-49 were somehow relevant to the instant case, its holding is simply that a savings institution has an option to report or not report a loss for financial purposes. That fact, we submit, undermines the relevance of Memorandum R-49 to the interpretation of the tax law.<sup>11</sup>

In any event, the courts have not accepted the pronouncements of nontax regulatory agencies as determining tax results. This point was strongly made by the Tax Court below in rejecting the binding effect of R-49 on the tax law. Judge Chabot of the Tax Court specifically

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<sup>10</sup> Memorandum from the Director of the OES to the Executive Staff Director of the Bank Board. (P.A. 2a).

<sup>11</sup> The relevance of Memorandum R-49 has also been undermined by Statement of Position ("SOP") 90-3 issued on February 13, 1990 by the Accounting Standards Division of the American Institute of Certified Public Accountants. SOP 90-3 concludes that debt instruments are "substantially the same" only if the instruments have the same primary obligor and meet five other criteria. It specifically notes that exchanged pools of single-family mortgages would not be considered substantially the same because the mortgages exchanged would not have the same primary obligor. While the FHLBB had permitted institutions which complied with R-49 to treat single-family mortgages exchanged as substantially identical for regulatory accounting purposes and consequently not to report the resulting losses on their books, SOP 90-3 now clarifies that losses incurred from any such exchanges should be reported for financial accounting purposes.

rejected Judge Sanders' statement in the *Centennial* case that a taxpayer cannot (by complying with R-49) "have his cake and eat it too," in other words, deduct a loss for tax purposes without booking a loss for regulatory accounting purposes. (P.A. 51a, 53a).

That Cottage received "substantially identical" mortgages is also directly contrary to *Hanlin v. Commissioner*, 108 F.2d 429 (3d Cir. 1939), *aff'g* 38 B.T.A. 811 (1938), which held that mortgages secured by different underlying properties are not "substantially identical" for tax purposes.<sup>12</sup> Finally, the Tax Court specifically found that the mortgages exchanged by Cottage were "materially different".<sup>13</sup>

The Fifth Circuit in *San Antonio* provides the best explanation of how mortgages could be materially different for tax purposes while substantially identical for regulatory accounting purposes as well as the weight to be given to the FHLBB's determination of substantial identity. The Court stated:

Admittedly at first glance the statement that two items can at the same time be "substantially identical" and "materially different" seems illogical. The critical consideration is, however, that the "substantially identical" language is employed by the FHLBB as an administrative accounting matter to carry out its own regulatory obligations. The "materially different"

<sup>12</sup> A complete discussion of the *Hanlin* case is set forth *infra* at p. 47. Moreover, the holding that the exchanged mortgages were substantially identical in the present case was particularly unwarranted because the Tax Court did not rely solely on *Hanlin's* rule that mortgages with different underlying properties are not "substantially identical"; the Tax Court went further and, based on the trial record, found as a matter of fact that the exchanged mortgages were likely to (and subsequently did) behave differently. (P.A. 37a).

<sup>13</sup> See discussion of Tax Court's finding of material difference at pp. 48-50, *infra*.

requirement is employed by a different agency, the IRS, in carrying out its separate regulatory responsibilities. Each of these phrases is a regulatory statement created for and used for a different administrative purpose.

The IRS urges that under *Ford Motor Credit Co. v. Milhollin*, 444 U.S. 555, 100 S. Ct. 790, 63 L.Ed 2d 22 (1980), the determinations of regulatory agencies are to be granted respect. So they are - but as to both the IRS and the FHLBB. The FHLBB is not in the business of interpreting the Internal Revenue Code. So also the IRS is not supposed to interpret the Federal Home Loan Bank Act. Here the IRS is arguing that deference should be shown in a tax determination case to a ruling by an agency which is not charged with enforcing the tax code. The FHLBB held that mortgages in R-49 exchanges are "substantially identical" for its own accounting. The IRS would have us defer to the FHLBB on the "substantial identity" but not on the "material difference" of the loans, and it would apply the "substantial identity" ruling (an accounting ruling) to the tax standard of "material difference." "[I]t has been consistently held that the accounting requirements of regulatory agencies are not controlling in the application of the revenue laws, which establish their own standards." *Bellefontaine Federal Savs. & Loan Ass'n. v. Commissioner*, 33 T.C. 808, 811-812 (1960). Hence, the FHLBB's determination that mortgages exchanged in an R-49 transaction are "substantially identical" for its accounting purposes is of no direct relevance when examining whether mortgages under R-49 are "materially different" for purposes of the Internal Revenue Code.

887 F.2d at 591.

The mortgage loans Cottage received in the reciprocal sale transaction pursuant to the requirements of R-49

may have been similar to the mortgage loans it transferred; but, they were certainly not "substantially identical" in accordance with *Hanlin*, 108 F.2d 429, and in fact were held by the Tax Court to be "materially different."

The second finding of the Sixth Circuit, namely, that Cottage did not record the loss on its books, is equally deficient. Under *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), the treatment of a transaction on a taxpayer's books does not control its tax treatment. Therefore, Cottage's failure to record the loss on its books is irrelevant for tax purposes.

#### D. THE SIXTH CIRCUIT'S DECISION IS UNSUPPORTED BY THE AUTHORITIES UPON WHICH IT RELIES.

The Sixth Circuit's decision in this case relies heavily upon *Shoenberg v. Commissioner*, 77 F.2d 446 (8th Cir. 1935), *cert. denied*, 296 U.S. 586 (1935), and *Horne v. Commissioner*, 5 T.C. 250 (1945). This reliance is misplaced. Those cases involved transactions in which a taxpayer disposed of and reacquired the *same* property rights. Thus they are inapplicable to transactions (such as those at issue here) in which indisputably *different* properties were exchanged. Moreover, the results reached in both of those cases were supported by statutory non-recognition rules – the predecessor to Section 1091 in *Shoenberg*<sup>14</sup> and the

<sup>14</sup> The taxpayer in *Shoenberg* tried to avoid the wash-sale rule in Section 118 of the Revenue Act of 1928 by having the stock he sold at a loss immediately repurchased by his controlled corporation, which then waited slightly more than 30 days to sell the stock back to him. The Eighth Circuit stated: "For all practical purposes, he used [his corporation] as an agency for purchasing, holding, and selling to him, stocks identical with those he sold to establish the claimed loss." 77 F.2d at 449 (emphasis added). Under agency principles, the sale and repurchase fell within the statutory wash-sale rule, resulting in the disallowance of the losses at issue.

predecessor to Section 1031 in *Horne*<sup>15</sup> – whereas no non-recognition rule is applicable to the transactions at issue here.

In addition, the Sixth Circuit improperly extended *Shoenberg's* rationale for denying a loss deduction, *viz.*, that the taxpayer is "no poorer than before the sale" because the identical stock was repurchased. 77 F.2d at 499. The taxpayer in *Shoenberg* was "no poorer" after the transactions because he ended up with the *exact same* property. However, the tax law cannot require – as the Sixth Circuit suggests – that taxpayers be poorer as the result of an exchange involving *different* properties in order for a loss to be deductible; if it did, taxpayers would be entitled to a deductible loss only in the event of a bad bargain. See *San Antonio*, 887 F.2d at 590 ("[r]ealization does not require that a taxpayer must be 'richer or poorer' as a result of the exchange itself" [original emphasis]).

The Sixth Circuit also misinterprets the "sham" and "substance-over-form" cases cited in its opinion (none of which is based on Section 165). *Keats v. United States*, 865 F.2d 86 (6th Cir. 1988), involved silver straddle transactions in which the taxpayer had no risk of loss and in fact suffered no real economic losses. In contrast, it is undisputed that Cottage suffered *real economic losses* on the mortgages exchanged in its transaction. In *Davis v. Commissioner*, 585 F.2d 807 (6th Cir. 1978), *cert. denied*, 440 U.S.

<sup>15</sup> The taxpayer in *Horne* purchased one certificate representing a "seat" on a stock exchange and sold another certificate to take a tax loss. The Tax Court held: "[T]he result was the same as if he had exchanged his certificate for that of another member. The deduction of a loss on such an exchange, that is, an exchange of property held for productive use in trade or business for property of a like kind to be held for such use, is expressly denied by Section 112(b)(1) of the Internal Revenue Code [now Section 1031(a)(1)]." *Horne*, 5 T.C. at 256. See *Perlin v. Commissioner*, 86 T.C. 388, 430 n.36 (1986) (characterizing *Horne* as a Section 1031 case).

981 (1979), the Court disregarded purported sales of apartment complexes to taxpayers by their wholly owned corporations, concluding the corporations had not in substance transferred the assets to the taxpayers. On the other hand, it is undisputed that the subject mortgage participations were actually transferred to new owners by Cottage. In *Owens v. Commissioner*, 568 F.2d 1233 (6th Cir. 1977), the Court held that the purchase for cash of stock in a shell corporation whose only asset was cash should be treated as an exchange of cash for cash, rather than a sale of the equity of a business. In contrast, it is undisputed that the assets exchanged by Cottage were in fact different mortgages.

There is no dispute in this case that Cottage suffered a loss on its mortgage loans when interest rates rose because of circumstances in the marketplace beyond its control. It is also undisputed that Cottage entered into the original transactions (the lending of money secured by mortgages) in the ordinary course of its savings and loan business. Cottage merely chose the time it wished to take its loss.<sup>16</sup> There was clearly a business purpose in originally acquiring the various mortgage loans Cottage later exchanged in the transaction at issue.

The case of *Widener, Trust No. 5 v. Commissioner*, 80 T.C. 304 (1983), *acq.* 1984-2 C.B. 2, is instructive in the reciprocal sale area. In *Widener*, the Tax Court held that a reciprocal sale of stock between two trusts produced a deductible loss under Section 165 of the Code to each trust, despite each trust's admitted motive to realize tax losses to offset portfolio gains in the same year. *Id.* at 310. Further, the court found that even though both trusts had the same beneficiary, they were not related in a tax sense

<sup>16</sup> See *Terry v. United States*, 10 F. Supp. 183 (D. Conn. 1934), which holds that if property is acquired in a transaction entered into for profit, a bona-fide loss incurred on disposing of the property is deductible even if the taxpayer sells it at a particular time in order to establish a tax loss.

but were separate taxpayers, and that the sales had substance because each trust permanently terminated its ownership of the stocks sold and the income flow they produced. *Widener, Trust No. 5*, 80 T.C. at 313. Cottage, like the taxpayer in *Widener*, entered into an arms-length transaction that resulted in a change in the flow of economic benefits. Just as in *Widener*, Section 165 allows Cottage's deduction of its losses in this case.

#### E. THE SIXTH CIRCUIT'S DECISION ATTEMPTS TO CREATE A NON-STATUTORY WASH-SALE RULE.

The Sixth Circuit applies a standard that is tantamount to a nonstatutory "wash-sale" rule within the framework of Section 165. The statutory wash-sale rule of Section 1091 denies loss deductions where a taxpayer sells or otherwise disposes of "stock or securities" and, within 30 days before or after such an event, acquires "substantially identical" stock or securities. Because mortgages are not stock or securities, Section 1091 cannot be applied in this case, and the Internal Revenue Service has not contended otherwise.<sup>17</sup> The Sixth Circuit's decision effectively ignores Section 1091's limitation to stock or securities. This approach makes the statutory limitation meaningless, frustrating the clear intent of Congress and creates a judicially imposed nonstatutory wash-sale rule for mortgage transactions.

Recent Congressional action illustrates that the Government's approach in this case is contrary to the intent of Congress in the reciprocal mortgage loan transaction area. In the Tax Reform Act of 1986, Congress enacted a new alternative minimum tax. It treated as a preference item to be included in "alternative minimum taxable income" seventy-five (75%) percent of the loss recognized

<sup>17</sup> The government conceded that none of the non-recognition sections of subtitle A of the Internal Revenue Code (which includes Section 1091) apply to this case. (P.A. 34a).

"on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities." Section 56(g)(4)(E) of the Internal Revenue Code of 1986. Congress would thus treat seventy-five (75%) percent of Cottage's loss (if it occurred today) as a preference item for the alternative minimum tax calculation, an obvious disincentive for any savings institution to engage in a reciprocal mortgage loan transaction. Congress (not the courts) is the proper party to change the tax laws and it has recently chosen to do so in this area.

#### F. SECTION 165 DOES NOT PREVENT DEDUCTION OF COTTAGE'S LOSS.

Section 165 does not prevent deduction of Cottage's loss. It provides, in general, that all losses sustained in a taxable year are deductible unless compensated by insurance or otherwise. Moreover, nowhere does Section 165 limit the losses of corporations, while it does limit the losses of individuals.<sup>18</sup> The Regulations under Section 165 provide that a loss must be evidenced by a closed and completed transaction, must be fixed by an identifiable event, and must be bona fide. Treas. Reg. § 1.165-1(b) and (d). The Regulations further provide that in determining the existence of these factors, substance shall control and not form. Treas. Reg. § 1.165-1(b). The Fifth Circuit in *San Antonio* concurred with the Tax Court's finding in this case that the transaction was closed and completed, changed the flow of economic benefits, and did not lack economic substance.

<sup>18</sup> Section 165(c) specifically limits the losses of individuals to certain types of transactions but contains no provision which limits the losses of Cottage. See *International Trading Co. v. Commissioner*, 484 F.2d 707 (7th Cir. 1973), rev'g 57 T.C. 455 (1971) (Corporate loss allowed on property not held for business or investment purposes).

The Fifth Circuit in *San Antonio* then stated that Section 165 and Treas. Reg. § 1.165-1(b) simply do not prevent allowance of the loss in this case:

The government's argument with reference to § 165 is a different facet of its previous argument that the loss sustained by SASA was not economically real. Even if it is conceded (as it was for summary judgment purposes) that there was no purpose for the R-49 transaction other than tax reduction, nevertheless SASA suffered a real economic reduction in the value of the mortgage participation interests it transferred and the economic reality of that loss was fixed by an identifiable event, an exchange of materially different items.

*San Antonio*, 887 F.2d at 592. The District of Columbia Circuit agreed that Section 165 does not prevent deduction of a loss in a reciprocal mortgage loan transaction. *Federal Nat'l Mortgage Ass'n v. Commissioner*, 896 F.2d 580 (D.C. Cir. 1990), aff'g 90 T.C. 405 (1988).

It is well settled that taxpayers are entitled to arrange their affairs to minimize taxes. *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934), aff'd 293 U.S. 465 (1935). See also *Sullivan v. United States*, 618 F.2d 1001, 1007-1008 (3rd Cir. 1980) which held that "there is nothing sinister in arranging one's affairs so as to minimize taxes." The taxpayer in this case merely chose the time it wished to take its loss and minimize its taxes. Memorandum R-49 permitted Cottage to exchange some of its mortgage loans for similar, but different loans and, at the same time, avoid recording the loss on its books if it chose to do so.

Cottage sustained a real, economic loss, which loss should be allowed for income tax purposes under Section 165.<sup>19</sup> This Court should adopt the proper reasoning of

<sup>19</sup> It is interesting to note that when Cottage exchanged its depreciated mortgage loans for the mortgage loan participations of its trading partners, Cottage ended up with a basis in

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the Fifth Circuit (and D.C. Circuit) that Section 165 does not prevent the deduction of Cottage's loss and reject the reasoning of the Sixth Circuit Court of Appeals.

**II. COTTAGE'S TRANSFER OF MORTGAGES RESULTED IN A REALIZED LOSS, AS A MATTER OF LAW, REGARDLESS OF WHETHER THE MORTGAGES COTTAGE RECEIVED DIFFERED MATERIALLY FROM THE MORTGAGES COTTAGE TRANSFERRED.**

**A. THERE IS NO "MATERIALLY DIFFERENT" REQUIREMENT; SECTION 1001 REQUIRES THE RECOGNITION OF GAIN OR LOSS ON ALL EXCHANGES UNLESS A STATUTORY EXCEPTION APPLIES.**

There is no "materially different" requirement for a loss on an exchange to be realized. In fact, Section 1001(c) requires that the entire amount of all realized gains or losses must be recognized unless a statutory nonrecognition provision applies.

The Government has previously argued that the first sentence of Treas. Reg. § 1.1001-1(a) limits realization of loss under Section 1001 to transactions in which property is exchanged for "other property differing materially in kind or in extent". In other words, it creates a substantive test for realization. There is no such "materially different" requirement in the statutory language of Section 1001. Moreover, the legislative history of Section 1001 discussed below supports the conclusion that Section 1001 is merely computational.

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its new loans that was lower than its original basis in its old loans. This new basis was equal to the fair market value of the new mortgage loans it received. Thus, while Cottage received a current loss deduction, it is currently reporting income on these new mortgage loans as principal payments are received.

The Sixth Circuit (P.A. 9a), the District Court in *First Federal Savings & Loan Association of Temple v. United States*, 694 F. Supp. 230 (W.D. Tex. 1988) and the concurring Tax Court judges, herein, all held that neither Section 1001(a) nor Treas. Reg. § 1.1001-1(a) states a substantive test for realization.

1. Sections 1001(a) and (b) merely set forth the manner of computing the amount realized on a transaction, and do not create a statutory standard for realization.

Sections 1001(a) and (b) merely set forth the manner of computing the amount realized on a transaction and do not create a statutory standard for realization. Section 1001(a), entitled "Computation of Gain or Loss," and Section 1001(b), entitled "Amount Realized," had their origins in Section 202 of the Revenue Act of 1924, Pub. L. No. 68-176, 43 Stat. 253 (hereinafter the "1924 Act"). The purpose of this section was "to show clearly the *method* of determining the *amount* of gain or loss from the sale or other disposition of property." (Emphasis added); see H.R. Rep. No. 179, 68th Cong., 1st Sess. 12 (1924); S. Rep. No. 398, 68th Cong., 1st Sess. 13 (1924). This computational method codified existing law, but did not codify a standard for realization. Subsequent legislative history also treats these provisions as merely computational in nature. See, e.g., H.R. Rep. No. 1, 69th Cong., 1st Sess. 5 (1926) (discussing the methods for determining how much depreciation is to be deducted in calculating the basis of property for determining gain under these provisions).

As Professor Bittker explains, Section 1001(a) "is purely computational; it determines the *amount* of the taxpayer's gain or loss but leaves to other provisions the task of determining whether the amount so computed is taxable or deductible, recognized or not recognized, and capital or ordinary." 2 B. Bittker, *Federal Taxation of Income, Estates and Gifts*, ¶ 43.1 at 43-1 (1981).

2. Section 1001(c) provides a general rule that, except as otherwise provided in the Code, all gain or loss is recognized from all exchanges.

Section 1001(c) provides generally that, except as otherwise provided in the Code, all gain or loss is recognized from all exchanges. Prior to the enactment of the original predecessor of Section 1001(c), gain or loss was not recognized on an exchange of property unless the property received had a "readily recognizable market value." Section 202(c) of the Revenue Act of 1921, Pub. L. No. 67-98, 42 Stat. 227 (hereinafter the "1921 Act"). Troubled that "[t]he provision is so indefinite that it cannot be applied with accuracy, nor with consistency," Congress enacted Section 203 of the 1924 Act. (See H.R. Rep. No. 179, 68th Cong., 1st Sess. 13 (1924)). Congress explicitly stated its intention to enact a broadsweeping recognition requirement:

It appears best to provide generally that *gain or loss is recognized from all exchanges* and then except specifically and in definite terms those cases of exchanges in which it is not desired to tax the gain or allow the loss. This results in definiteness and accuracy and enables a taxpayer to determine prior to the consummation of a given transaction the tax liability that will result therefrom.

*Id.* (emphasis added); S. Rep. No. 398, 68th Cong., 1st Sess. 14 (1924). Thus, Congress moved from a case-by-case analysis of recognition based on the market value of the assets received to a blanket rule that all gain or loss on an exchange is recognized in the absence of an applicable statutory exception.

Because gains and losses that are recognized must necessarily be realized, Congress' mandate that gain or loss be recognized on all exchanges necessarily acknowledges that gain or loss is realized on all exchanges. By requiring that "the entire amount of the gain or loss" on the exchange of property, as determined under Section 202 of the 1924 Act (the computational rules discussed in

the preceding section), "*shall be recognized*" except as otherwise provided, Section 203(a) of the 1924 Act effectively required recognition (and realization) of gain or loss on all exchanges except in the case of specific exceptions.

The Code provisions at issue in this case reflect the Congressional intent set forth above: Section 1001(c) – the successor to Section 203 of the 1924 Act – provides generally that all gain or loss is recognized from all exchanges, except as otherwise provided in Subtitle A of the Code.<sup>20</sup> The entire amount of gain or loss on the exchange of property to be so recognized is measured under Section 1001(a) and (b) (which includes the successor to the computational rules of the 1924 Act). The Code then provides for nonrecognition of gain or loss in certain limited circumstances such as like-kind exchanges (Section 1031), wash sales (Section 1091), stock-for-stock exchanges (Section 1036), and certain other corporate reorganizations (e.g., Section 354). The Government has never contended that any nonrecognition provision in Subtitle A of the Code applies to the transfer of the mortgage loan participations in dispute (except to the extent that Section 1001 may be viewed as a nonrecognition provision). (P.A. 34a). Moreover, regulations confirm that the nonrecognition provisions are "exceptions from the general rule requiring the recognition of all gains and losses," Treas. Reg. § 1.1002-1(b);<sup>21</sup> and these rules "are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception," Treas. Reg. § 1.1002-1(b).

<sup>20</sup> Several rulings published by the Internal Revenue Service also state this rule. See, e.g., I.T. 2896, Vol. XIV-1 C.B. 96 (Jan.-Jun. 1935) (explaining that [under the 1924 version of this statutory requirement], "*every exchange results in a gain or loss for income tax purposes unless the exchange comes within one of the statutory exceptions*") (emphasis added).

<sup>21</sup> The substance of Section 1002 was moved into Section 1001(c) pursuant to the Revenue Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520.

3. A 1920 Regulation does not establish a "materially different" standard under Section 1001.

Treas. Reg. § 45, art. 1563, was promulgated in 1920. Contrary to the Government's arguments below, this regulation does not establish a "materially different" standard under Section 1001. This regulation, which was superseded over fifty years ago, permitted a loss to be realized on an exchange only if the property received was "essentially different" from the property disposed of.<sup>22</sup> Treasury eliminated the "essentially-different" language from the regulation after Congress adopted the broad-sweeping recognition requirement in 1924. Both the Tax Court below (P.A. at 38a) and the District Court in *First Federal of Temple* determined that Treasury abandoned this essentially different requirement. *First Fed. Savs. & Loan Ass'n of Temple v. United States*, 694 F. Supp. 230, 240 n.11 (W.D. Tex. 1988).

The history of the statutory sections interpreted by this 1920 regulation further confirms that the deletion of the essential-difference requirement was intentional. The 1920 regulation interpreted Section 202(b) of the Revenue Act of 1918, Pub. L. No. 65-254, 40 Stat. 1057 (1919) (hereinafter the "1918 Act"), which provided that "[w]hen property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value" except in the context of certain corporate reorganizations. In other words, all exchanges required an analysis of the property received, including a determination of the fair market

<sup>22</sup> Assuming *arguendo* that the 1920 regulation (rather than the current regulation) is controlling, and that the reference to "essentially different" embodies a "material difference" test, it is a test that Cottage's exchanges meet. See discussion *infra* at p. 43. All eleven judges who joined in the Tax Court opinion below agreed.

value of that property. This was the law when, in 1920, Treasury promulgated this regulation. According to the regulation, a gain or loss on an exchange of property under this statutory property exchange rule is realized if the property received is (1) "essentially different from the property disposed of," and (2) has a market value. Treas. Reg. § 45, art. 1563 (1920 ed.).

Unfortunately, the 1918 version of Section 202(b) gave rise to substantial uncertainty and litigation, forcing Congress to amend it in 1921. Observing that, prior to its amendment, Section 202 created a presumption in favor of taxation, the Senate Finance Committee explained that the new language "modifies that presumption by providing that in the case of an exchange of property for property no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value . . ." S. Rep. No. 275, 67th Cong., 1st Sess. 11 (1921) (emphasis added).<sup>23</sup> Congress thus adopted Treasury's market-value standard, but did not adopt Treasury's essential-difference standard. Moreover, the statutory limitation on recognition of gains and losses from property exchanges adopted in 1921 indicates that such exchanges do give rise to realization, notwithstanding the 1920 regulation.

Three years later, in an effort to provide more certainty in the tax law, Congress enacted Section 203 of the 1924 Act – the original predecessor to 1001(c) – and thereby intentionally adopted a blanket rule that all gain or loss on an exchange is recognized in the absence of an applicable statutory exception. The 1920 regulation was inconsistent with Congress' intent to create a rule of certainty in Section 203; thus, it was properly abandoned.

<sup>23</sup> See Appendix for text of Section 202(c) of the Revenue Act of 1921, as amended.

4. The legislative history of the statutory exceptions to recognition explicitly acknowledges that loss is realized and recognized on exchanges of notes, without regard to a materially different standard.

The legislative history of the nonrecognition provisions, including the like-kind exchange rule, shows that gain or loss is realized on all exchanges. In 1921 Congress amended Section 202(c) of the Act to provide an exception to recognition of gain or loss "[w]hen any such property held for investment or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use." Sec. 202(c)(1) of the 1921 Act. Because this like-kind exchange rule provoked wide-spread abuse by taxpayers seeking to shield their gains from recognition,<sup>24</sup> Congress acted, in 1923, to exclude "stock, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest" from the like-kind exchange rule. Sec. 202(c), Revenue Act of Mar. 4, 1923, Pub. L. No. 67-545, 42 Stat. 1560. This exclusion existed in 1980 (as it does today) in Section 1031(a). The result of excluding "notes or other evidences of indebtedness" from the like-kind exchange rule is that there is no nonrecognition section to apply to Cottage's exchange. Accordingly, Section 1001(c) acts to require Cottage to recognize its loss on the transaction at issue.

<sup>24</sup> According to A. W. Melon, Secretary of the Treasury in 1923; "Many brokers, investment houses and bond houses have established exchange departments and are advertising that they will exchange securities for their customers in such a manner as to result in no taxable gain." Letter from A. W. Melon to the Hon. William R. Green (Jan. 13, 1923), H.R. Rep. No. 1432, 67th Cong., 4th Sess. 1-2 (1923). The abuse was especially troublesome because cash consideration received in addition to the exchanged securities also escaped taxation. *Id.*

Legislative history confirms that, because notes are excluded from Section 1031, an exchange of notes is taxable. The language of Section 1031(a) in 1980 is the verbatim language used in the 1934 version of the like-kind exchange rule.<sup>25</sup> In 1934, when Congress declined to change that language, the House Report specifically acknowledged that the result of the like-kind exchange rule is that profit and loss on some exchanges are not recognized, but that "*profit or loss is recognized in the case of exchanges of notes or securities, which are essentially like money.*" H.R. Rep. No. 704, 73d Cong., 2d Sess. 13 (1934) (emphasis added). In the fifty years since Congress considered amending this provision, it has not done so.<sup>26</sup> This Court should not do so now.

This Court recently considered the proper interpretation of statutory exclusions in *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988). In that case, the Government argued that the taxpayer's assets must be treated as capital assets because they fell within the literal statutory definition of capital assets, and outside the statutory exclusions from that definition. The Court agreed and noted that the legislative history of the provisions involved supported a conclusion that the statutory exceptions are exclusive. *Id.* at 217. Similarly, the legislative history of the nonrecognition provisions supports a conclusion that these exceptions are exclusive. As conceded by the Government in this case (P.A. 34a), Cottage's loss falls outside any of the nonrecognition provisions. Therefore, Cottage's loss must be recognized.

<sup>25</sup> See Appendix for the language of Section 112(b)(1) of the Revenue Act of 1934, Pub. L. No. 73-216, 48 Stat. 680.

<sup>26</sup> See discussion of Judge Cohen's concurring opinion in the Tax Court with respect to Section 1031's exclusion of evidences of indebtedness, *infra* at p. 41.

**B. THE "REALIZATION TEST" IS SIMPLE: IF THERE HAS BEEN A CHANGE IN THE VALUE OF PROPERTY, THEN GAIN OR LOSS IS REALIZED FOR TAX PURPOSES WHEN A SALE OR OTHER DISPOSITION OF THE PROPERTY OCCURS.**

Realization of gain or loss occurs upon a change in value of property when there is a sale or other disposition of the property. Sections 1001(a)-(c). The most eloquent (and accurate) statement of this objective concept of realization appears in Judge Smith's opinion in *First Federal Savings and Loan Association of Temple*, as follows:

Realization is not concerned with a taxpayer's relative economic position before or after a sale or other disposition. Realization has occurred as soon as 1) there has been an actual change in net worth of a taxpayer's property (it is undisputed that the loans had depreciated in value) and 2) there has been a sale or other disposition of the property (it is undisputed that there was at least an exchange of loan pools which qualified as an "other disposition"). Whether the "exchange" or "other disposition" involves property which is of like kind or is not materially different has nothing to do with the realization of any gain or loss associated with the sale or other disposition of property for it is at that point that the decline in value of property can be fixed due simply to the fact of the transaction regardless of its economic consequences.

694 F. Supp. at 240.

A taxpayer's relative economic position is not relevant with respect to realization.<sup>27</sup> Taxpayers are always in

<sup>27</sup> In this case, if Cottage had sold its depreciated loans (or participations in mortgage loans) in the open market for cash, it clearly would have realized and recognized a deductible loss for tax purposes. If Cottage then had taken these cash proceeds and either repurchased different mortgage loans in the open

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the same economic position immediately before a sale as immediately after a sale if the transaction was bona-fide and at arms length.<sup>28</sup> It is undisputed that Cottage incurred an economic loss when its mortgages declined in value. It is also undisputed that Cottage disposed of its mortgages in a bona-fide arms-length transaction. (P.A. 52a). Cottage's loss is clearly realized.

1. *Eisner v. Macomber* established that a mere increase or decrease in the value of a taxpayer's asset does not constitute income or loss.

It is well established that no gain or loss is realized on a mere increase or decrease in the value of a taxpayer's assets.<sup>29</sup> Cottage did not automatically "realize" a loss for tax purposes when the value of its mortgages declined as a result of increasing interest rates, although its loss was a very real economic loss. Its loss, albeit real, was not "realized" until an identifiable event occurred that fixed the time and amount of the loss under Sections 1001(a) and 1001(b).

This general rule was not always so clear, however, and early judicial authority painstakingly articulated the

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market or originated new mortgage loans, it would still be in the same economic position even though it clearly disposed of its mortgages in a bona-fide arms-length transaction.

<sup>28</sup> For example, a sale of a \$100 mortgage worth \$80 for \$80 in cash results in realization of a \$20 loss. The seller and buyer are both in the same economic position just before the sale as after because both still have property worth exactly \$80. See discussion of the District Court's misunderstanding of this concept in *Centennial*, *supra* note 32 at p. 37.

<sup>29</sup> In the absence of this general rule, thousands of taxpayers would realize gain or loss with respect to their stock investments regularly - even on a daily basis - as the market fluctuates.

standards for determining when a gain or loss is realized. In *Eisner v. Macomber*, 252 U.S. 189 (1920), this Court discussed at length the circumstances in which a taxpayer should realize income, holding that receipt of a stock dividend does not result in taxable income.<sup>30</sup> In essence, this Court focused on whether there had been some identifiable event, rather than a mere change in value, that would trigger taxable income.

In *Eisner v. Macomber*, the taxpayer had received a stock dividend that increased the number of her shares, but not her ownership percentage, of the corporation. She did not sell, transfer, or in any way dispose of any assets. Moreover, the stock distributed to the taxpayer did not provide her with any additional claim to corporate earnings. This Court therefore had to decide if the taxpayer should recognize a gain on her stock dividend, notwithstanding the fact that she had not disposed of her stock and had not received anything different from what she already owned.

This Court's attention to the fact that "the corporation is no poorer and the stockholder is no richer than they were before," *Eisner* at 203, reflected its determination that the stock dividend did not effect a transfer from the corporation to the shareholder, i.e., that the shareholder had not "received or drawn . . . for his separate use, benefit and disposal" an amount that could be treated as income. *Id.* at 207 (emphasis in original).<sup>31</sup> In *Eisner v.*

<sup>30</sup> The issue in *Eisner v. Macomber*, 252 U.S. 189 (1920), whether Congress had the power to tax a stock dividend as income, arose under the Revenue Act of September 8, 1916, 39 Stat. 756 *et seq.* That *Eisner v. Macomber* reflects the early stages of the realization analysis is evidenced by the fact that four Justices, including Mr. Justice Brandeis and Mr. Justice Holmes, dissented from this landmark opinion.

<sup>31</sup> It is useful to note that the Supreme Court paid little heed to the economists' theories. *Eisner v. Macomber*, 252 U.S. at 206. As R. Magill observes, "one cannot tell whether the Court

(Continued on following page)

*Macomber*, there simply had been no identifiable event to effect a change in the taxpayer's rights. By contrast, after Cottage's transfer of the 252 mortgages to the other institutions, those mortgages were no longer Cottage's property and Cottage no longer had any rights, or any business risks, with respect to those transferred mortgages.

The conclusion in *Eisner v. Macomber* that no income was realized on the stock dividend because "the corporation is no poorer and the stockholder is no richer than they were before," also reflects the rule that there is no realization without some change in the taxpayer's economic position. Absent some increase or decrease in value (like the one incurred by Cottage when its mortgage portfolio declined in value) there can be no gain or loss even if the taxpayer disposes of his asset.<sup>32</sup>

Gain or loss, if any, is realized on an asset at the point at which the taxpayer relinquishes all dominion and control of his asset. Section 1001(a); See *Commissioner v. Brown*, 380 U.S. 563 (1965). For the taxpayer in *Eisner v. Macomber*, that point never came. For Cottage, that point

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regarded the definitions of economists as theoretically unsound; or whether, on account of various unexpressed practical considerations, the Court decided that a different definition would work better." R. Magill, *Taxable Income* 19 (Rev. ed. 1945).

<sup>32</sup> The District Court in *Centennial Savs. Bank FSB v. United States*, 682 F. Supp. 1389 (N.D. Tex. 1988), *aff'd in part and rev'd in part*, 887 F.2d 595 (5th Cir. 1989), *cert. granted*, 59 U.S.L.W. 3243 (U.S. Oct. 1, 1990) (No. 89-1926), misunderstood this test to require that the taxpayer be richer or poorer *immediately after* the exchange than *immediately before*. Under that test, no gain or loss would ever be realized on any fair market value exchange — because both parties to the exchange would own exactly the same value immediately after the exchange as immediately before if they were dealing at arms length.

was December 31, 1980, when it relinquished all dominion and control of 252 mortgages.

2. Subsequent judicial authority established that the realization of income or loss can be triggered by either a disposition of the taxpayer's property or by an exchange for a different interest in the same property.

The realization test enunciated in subsequent cases (set forth below) does not require that exchanged properties differ materially – it requires only that a taxpayer (1) sell or otherwise dispose of his property, or (2) exchange the property for a different interest in the same property. These cases establish guidelines for determining what differences must exist between exchanged properties to trigger realization without a disposition of the taxpayer's original property. The cases conclude that a taxpayer may realize gain or loss with respect to property without disposing of his interest in the property, if he receives an interest in the property that is "essentially" or "materially" different from his original interest in the same property.

This Court held in *Weiss v. Stearn* that for a taxable gain to occur in an exchange, the taxpayer must receive "a thing really different than what he theretofore had". *Weiss v. Stearn*, 265 U.S. 242 (1924). In *Weiss v. Stearn*, the shareholders of the original corporation exchanged their stock for half the stock in a new corporation with the same business, plus cash from a third party.

The Court in *Weiss v. Stearn* concluded as follows:

We cannot conclude that a mere change for purposes of reorganization in the technical ownership of an enterprise . . . followed by issuance of new certificates constitutes gain separated from the original capital interest. Something more is necessary – something which gives the stockholder a thing really different from what he theretofore had. (Emphasis added.)

265 U.S. at 254. Therefore, the old shareholders were taxed on the cash sale but not on the exchange of the old shares for new shares.

The narrow scope of the nonrealization rule in *Weiss* was emphasized shortly thereafter in *Marr v. United States*, 268 U.S. 536 (1925). In *Marr*, a taxpayer received a different interest in the same corporation, and therefore realized income. *Marr* involved a corporation that was organized under the laws of a different state, but received the assets and assumed the liabilities, from the old corporation. The taxpayer received stock in the new corporation in exchange for his stock in the predecessor corporation. The "business enterprise" in which the taxpayer held stock remained exactly the same. The Government argued, and this Court agreed, that gain in value must be realized when the gain is " . . . represented by an essentially different interest in the same business enterprise or property." 268 U.S. at 540 (emphasis added).

In *Marr*, the formality of a legally different transferee was all the Government said was needed to "realize" gain; and realization occurred, it argued, where the seller received either (1) an interest in different property, or (2) a different interest in the same property.<sup>33</sup> Thus, a "realization event" occurred when the taxpayer exchanged stock in one corporation for stock in a successor corporation with the same assets and business as the original corporation, notwithstanding the court's finding that the taxpayer had not sold or otherwise disposed of his interest in the property.<sup>34</sup> *Marr* thus limits the *Weiss*

<sup>33</sup> The Supreme Court so summarized the Government's argument in *Marr*.

<sup>34</sup> In order to avoid the harsh consequences that would result from taxing these reincorporation transactions, Congress thereafter enacted yet another nonrecognition statute, Section 368(a)(1)(F), that provides a statutory exception to the general rule that a reincorporation of a corporation produces a recognized gain or loss. This nonrecognition provision, like the ones cited earlier, would be unnecessary if the exchange was not a realization event.

nonrealization rule to the narrow circumstances where the taxpayer has before and after the *same* interest in the *same* property.

*Emery v. Commissioner*, 166 F.2d 27 (2d Cir. 1948), *aff'g* 18 T.C. 1979 (1947), utilized this Court's "different interest in the same property" test for realization which was developed in the early Supreme Court cases. In *Emery*, the taxpayer exchanged bonds for bonds of the *same* obligor (the City of Philadelphia). Thus, the taxpayer continued to hold his interest in Philadelphia bonds. The new bonds were convertible into registered form, but were identical in all other respects. Although the taxpayer had clearly not disposed of the city's obligation to him, the court held that he nonetheless recognized income; he had received "something really different from what he theretofore had." *Emery*, 166 F.2d at 30.

These cases emphasize that when a taxpayer retains the *same* rights in the *same* asset there has been no "identifiable event" to trigger realization. Unless the taxpayer receives different property or a different interest in his property, there has in essence been no real "exchange"; the taxpayer continues to hold what he had before – not merely something substantially similar. The mortgages Cottage received were clearly different mortgages from the mortgages it transferred because they had different obligors and different collateral. Cottage also ended up with a different interest in the property, namely, participations in mortgage loans. (P.A. 37a). Thus, Cottage met the different property test as well as the different interest test even though realization only requires it meet one such test. The tax law requires that its loss must be realized.

**C. JUDGE COHEN'S CONCURRING OPINION IN THE TAX COURT, THAT THERE IS NO MATERIALLY DIFFERENT REQUIREMENT, IS LEGALLY CORRECT.**

Judge Cohen's concurring opinion (P.A. 54a) in the Tax Court, which states that there is no materially

different requirement in Section 1001, is legally correct. She states that Treas. Reg. § 1.1001-1(a) deals strictly with computation of gain or loss. The essence of her opinion rests less on a debate about the converse of Treas. Reg. § 1.1001-1(a)<sup>35</sup> than on the argument that Treas. Reg. § 1.1001-1(a) is subordinate to the statute (Section 1001(c)), and, under the statute, "as a matter of law there is no requirement applicable in this case that the properties exchanged differ materially in kind or in extent." (P.A. 56a).<sup>36</sup> The Sixth Circuit's decision in this case seems to agree with Judge Cohen's approach. (P.A. 9a, 10a).

On the particular facts here, Judge Cohen appears to believe that the mortgages did represent different property rights *by reason of* the different obligors and collateral on the respective groups of mortgages. Hence, there were different property rights exchanged and realization did occur within the meaning of Section 1001.<sup>37</sup>

Finally, Judge Cohen points out that the only relevant nonrecognition provisions are the like-kind exchange rules of Section 1031 and the wash sale rules of Section 1091. Since neither sections are applicable here, and "Section 1031 expressly excludes applicability of the 'like-kind' exchange rules to evidence of indebtedness", she suggests applying the maxim "*Expressio unius est exclusio alterius*" (the expression of one thing implies the exclusion of another thing). In other words, since mortgages were specifically excluded from the like-kind exchange

<sup>35</sup> Judge Chabot's discussion about the converse of Treas. Reg. § 1.1001-1(a) is set forth at P.A. 38a, 39a note 13 and 14. Judge Cohen's concurring opinion is fully set forth at P.A. 54a-56a.

<sup>36</sup> It is obvious that Judge Cohen would not find realization in an exchange of identical property based upon the early Supreme Court cases (*See discussion supra* at pp. 35-40).

<sup>37</sup> An accurate statement of the concept of realization appears in Judge Smith's opinion in *First Federal of Temple* at p. 34.

rules of Section 1031, Congress obviously intended that exchanges of mortgages must therefore be realized and recognized. The Government's very own regulation requires such a result. Treas. Reg. § 1.1002-1(b).<sup>38</sup>

**D. ADOPTION OF THE GOVERNMENT'S THEORY WOULD CREATE AN ADMINISTRATIVE NIGHTMARE.**

The adoption of the Government's theory in this case, that material differences are a prerequisite to realization, and that economic substitutes cannot be materially different, would create an administrative nightmare. If this theory is adopted, then the Congressional goal (expressed in 1924 relating to what is today Section 1001) of providing taxpayers with some certainty with respect to recognition of gains and losses will never be met.<sup>39</sup> Taxpayers and courts will spend countless hours trying to determine whether property received on an exchange is "materially different" from, or a mere economic substitute for, the property transferred. Every exchange will create fact issues worthy of jury trials and economic experts, all in the name of "convenience."

Under the Government's theory, taxpayers who exchange shares of one mutual fund for another and can prove that the aggregate stock investment of one fund was not economically different from the other, will be able to defer taxation of gain indefinitely.<sup>40</sup> Congress closed this door in 1924. This Court should not reopen it now.

<sup>38</sup> The entire text of Treas. Reg. § 1.1002-1(b) is set forth in the Appendix at 4a.

<sup>39</sup> See discussion of Section 203 of the Revenue Act of 1924, Pub. L. No. 68-176, 43 Stat. 253, *supra* at p. 28.

<sup>40</sup> See Discussion of *Centennial* opinion, *supra* note 32, at p. 37.

At best, taxpayers – and the courts – will face enormous, costly burdens and much confusion in determining whether property exchanged is materially different. At worst, a new era of tax shelters will begin as taxpayers seek to shield their gains by exchanging appreciated property for other economically similar property.

**III. EVEN IF A "MATERIALLY DIFFERENT" STANDARD DID APPLY TO THE TRANSACTIONS AT ISSUE, THE TAX COURT WAS CORRECT IN CONCLUDING THAT THE MORTGAGES COTTAGE RECEIVED WERE MATERIALLY DIFFERENT FROM THE MORTGAGES COTTAGE TRANSFERRED AND COTTAGE'S LOSS SHOULD BE REALIZED AND RECOGNIZED.**

**A. SIMILARITY OF RISKS AND ECONOMIC SIMILARITY HAVE NO APPLICATION IN TAX LAW.**

The Government has argued below that there is an alleged similarity of "risks" or "economic similarity" with respect to the mortgages transferred and received by Cottage and this should act to prevent Cottage from deducting its loss. However, the tax law does not turn on economists' or laymen's concepts and similarity of risks and economic similarity have no application in the tax law.<sup>41</sup> The notions of "realization" and "recognition" are tax concepts without parallel in other professional disciplines. The measurement of comparable income streams may have significance to economists. However, the tax law depends exclusively on practical concerns of administering the law.

Judge Korner's opinion for the Tax Court in *Federal National Mortgage Association v. Commissioner*, 90 T.C. 405 (1988), provides, we think, the definitive statement from

<sup>41</sup> This Court rejected the necessity of risk-shifting in the context of determining whether a sale took place in *Commissioner v. Brown*, 380 U.S. 563 (1965).

the tax standpoint about "risk" factors and economic analysis of income streams with respect to mortgages exchanged by savings and loans. The Tax Court pointed out that economic analysis relates to the relative fair market values of the obligations exchanged, and that equality of fair market values is not relevant taxwise to the question of whether realization of gain or loss has occurred. The Court stated:

The fact that the market values of the two pools of mortgages exchanged were the same, or almost the same, is not determinative. Current market value reflects an amalgam of the interest rate, the face amount and the maturity of the obligation. It is not necessarily a clear reflection of the value of the underlying security, the credit-worthiness of the borrower, or of varying local economic circumstances which may have future effect on these factors. The first mortgage bond of railroad A is not the same property in kind or quality as first mortgage bond of food processing company B, even though the two bonds may carry the same face amount, the same rate of interest, the same maturity, and may happen, at the moment, to be quoted at the same price in the open market. We hold that the similarities here do not result in there being no material differences in the mortgages.

90 T.C. at 423.

Professor Roswell Magill best articulated the fundamental difference between the operation of our tax system in the area of realization from sales or exchanges of property, and the approach of economics and other professions. His book, *Taxable Income*, makes these points in connection with the pre-statutory reorganization decisions of the Supreme Court, discussed earlier. R. Magill, *Taxable Income* (rev. ed. 1945). Several of the relevant passages express Professor Magill's points as follows:

*Weiss v. Stearn* and *Marr v. U.S.* may be reconciled upon the basis of formal differences in their facts, notably the differences in the states

of incorporation, and in the characteristics of the new securities, referred to in the majority opinion. But it is clear that the division of opinion between the majority and the minority in *Marr v. U.S.* cuts more deeply. The majority sanctions computation and taxation of the accumulated gain when the stockholder receives securities legally different in kind; the minority would not, if the two enterprises are substantially identical. The test of the majority is clearly much easier of application by administrative officials. It has the further virtue of leaving Congress comparatively untrammelled by constitutional restrictions in working out methods for the taxation of reorganizations, a factor of great practical significance.

\* \* \*

It is clear, in the first place, that the Court did not regard a mere accretion in value during the taxable year as constituting income; there must have been some change in the form or the extent of the taxpayer's investment. *But there need be no substantial change in the character of the investment, if a formal change has occurred . . .* A change in the form or extent of an investment is easily detected by a taxpayer or an administrative officer. It affords a reasonable and convenient occasion for taking stock of the accretion in value to the investment as represented by the distribution which the stockholder has received. Such a policy of taxing gains obviates valuations so far as possible on the one hand, and an indefinite postponement of the taxation of accrued gains on the other." (Emphasis added).

*Taxable Income*, 76-80.<sup>42</sup> Professor Magill's comments with respect to taxation of gains are equally applicable to the taxation of losses.

The Government has argued below that the marketplace perceived the mortgages exchanged by Cottage

<sup>42</sup> R. Magill, *Taxable Income* (rev. ed. 1945).

as equivalent. Section 1001 could not be administered if this Court (or other courts) had to define a relevant "marketplace" and then determine exactly how that market "perceived" the mortgage loans exchanged in a reciprocal sales transaction.<sup>43</sup>

The Government has previously argued that mortgages that are economic substitutes for one another are not materially different, and since a taxpayer is in the same economic position before and after the exchange of such mortgages, there is no realization. However, Treas. Reg. § 1.1001-1(a), to the extent it is not just computational and places a precondition upon loss realized in an exchange, requires only that property being exchanged differ "materially in either kind or extent." It does not say "differing materially for economic purposes" or "differing materially and predictably in economic risk." And, it, most assuredly, does not say that a taxpayer must be "richer or poorer" as the result of the exchange itself.

It is true that Cottage may not have been overly concerned with individual differences in the mortgages it exchanged in the R-49 transaction. However, a seller's personal views of the financial characteristics of the properties exchanged, or "market" similarities between the properties sold and received, are not relevant to a determination of realization. We have reiterated throughout this brief that the tax determination of whether gain or loss has been realized turns on objective factors. The Government would surely insist on that rule if *gain* were involved in an exchange; would the Government concede that a taxpayer can escape realization of *gain* on an exchange of similar kinds of investment properties or

<sup>43</sup> Any transaction involving similar assets would be perceived by the marketplace as equivalent. See the example at note 44, *infra*.

even on an exchange of mortgages which meet the criteria of R-49?<sup>44</sup> We think not.

The objective factors which determine that the mortgages in this transaction are materially different are the different obligors, the different underlying collateral (real estate), the different interest (participations) in the mortgages and the different collections received by Cottage on the loan participations. (P.A. 37a). No other difficult-to-measure concepts of "economic reality" or similarity are relevant for this purpose. It is also not necessary to penetrate into the subjective attitudes of the parties to an exchange to determine how they may have individually focused on specific characteristics of the properties they were exchanging. Likewise, the practicalities of administering the law do not require the courts to undertake broad studies of how investors generally view the characteristics of the properties involved in a particular exchange.

**B. THE HANLIN CASE REQUIRES THAT THIS COURT AFFIRM THE TAX COURT'S DECISION THAT THE MORTGAGE LOANS COTTAGE TRANSFERRED WERE "MATERIALLY DIFFERENT" FROM THE MORTGAGE LOANS IT RECEIVED AND THUS ITS LOSS SHOULD BE REALIZED AND RECOGNIZED.**

The Third Circuit decision in *Hanlin v. Commissioner*, 108 F.2d 429 (3d Cir. 1939), *aff'g* 38 B.T.A. 811 (1938) requires that this Court affirm the Tax Court's decision that the mortgage loans Cottage transferred were "materially different" from the mortgage loans it received. Its loss should thus be realized and recognized. *Hanlin* is

<sup>44</sup> For instance, would the Government allow a taxpayer to escape gain if he exchanged an Exxon bond for a Mobil bond, both with identical interest rates, par value, maturities and fair market value just because the taxpayer was unconcerned with the differences in the companies issuing the bonds and because the marketplace valued these bonds at the same price?

particularly relevant because it involved sales and purchases of bonds secured by pools of mortgages. *Hanlin* dealt with the applicability of the wash sale provision of the Code (the predecessor of current Section 1091) and the definition of "substantially identical" for purposes of such Section with respect to two different kinds of transactions: (1) a sale and purchase of various bonds of the same issuer, and (2) sales and purchases of various bonds of different issuers.

The Third Circuit held that the same-issuer bonds were substantially identical to each other, but that the different-issuer bonds were not substantially identical. A reading of the Third Circuit's opinion reveals that the court did test substantial identity in the *same-issuer* transaction somewhat by reference to the attitudes of ordinary investors, but did not apply such a test where the issuers of the bonds sold and purchased were not the same. Although the Tax Court (Board of Tax Appeals) decision in *Hanlin* had found lack of substantial identity among the different-issuer bonds by reason of the different issuers, the Third Circuit rested its rejection of the wash sale limitation on the fact that the Land Bank bonds in situation (2) were all secured by physically different collateral. The Court stated:

Though the average sense of obligation may well be the same, even an economist must recognize, *by geographical definition*, a salient divergence in, say the type (and marketability) of crops produced – or, perhaps, the likelihood of dust storms. This difference, we think, deprives the bonds of one Land Bank of substantial identity with those of another.

108 F.2d at 431 (emphasis added).

Cottage exchanged mortgages with different obligors and different underlying real estate collateral. In such a transaction, the real estate risks are inherently different and there are differences, as stated by the *Hanlin* decision, "by geographical definition." It should also be emphasized that the Tax Court specifically found that

Cottage's position in the instant case was *even stronger* than the taxpayer in *Hanlin* with respect to the bonds of the different Federal Land Banks. (P.A. 45a).

It should not be necessary to review and compare the lifestyles and job prospects of individual homeowners (and their propensity to pay their mortgages) and the real estate investment values of their residences in order to determine whether gain or loss was "realized" on an exchange of mortgages. Our tax system would become impossible to administer if this were necessary.

It is interesting to note that Memorandum R-49 takes geographical differences into account. For instance, R-49 requires that the mortgage loans be in the same state. Yet if this or other factors of the R-49 criteria were not satisfied in some minor detail (such as real estate collateral in two different states but close in physical proximity and economic climate), would the Government necessarily allow a loss deduction? The Government's position that mortgages of different issuers secured by different collateral are not materially different would destroy effective tax administration.

It is impossible to believe this Court will undo the basic administrative concepts which have long underlay the fundamental concepts of tax "realization" of gain or loss.

Therefore, even assuming that Treas. Reg. § 1.1001-1(a) correctly states the legal requirement (which we dispute) that realization occurs from an "exchange of property for other property differing materially in kind or extent", the Tax Court (with ten judges agreeing with Judge Chabot's majority opinion) carefully reviewed all of the evidence before it<sup>45</sup> and concluded that "the property petitioner acquired differs 'materially . . . in kind' from the property petitioner transferred." In fact, the Sixth Circuit's opinion in this case agreed with the Tax Court that Cottage's loss was realized and recognized:

<sup>45</sup> In fact, the Tax Court "scrutinized the record with particular care." (P.A. 36a).

We believe the loss in this case was technically realized in the sense that an earlier decline in value of the fixed-rate mortgage loans was fixed by an identifiable event – the “reciprocal sales” transaction. Since there is no Code exception that applies, under 1001(c) the loss must be recognized. (P.A. 10a).

The mortgage loans Cottage received in the transaction at issue are clearly materially different from the mortgages it transferred.<sup>46</sup> Cottage’s loss on the exchange of mortgage loans for other mortgage loans (with different obligors and collateral underlying the mortgages) should be realized and recognized under Section 1001 and Treas. Reg. § 1.1001-1(a). For the reasons stated above, the loss should also be allowed as a deduction under Section 165.

### CONCLUSION

For the foregoing reasons, the decision of the Court of Appeals for the Sixth Circuit should be reversed.

Respectfully submitted,

DENNIS L. MANES\*  
SCOTT M. SLOVIN  
SCHWARTZ, MANES & RUBY  
2900 Carew Tower  
441 Vine Street  
Cincinnati, Ohio 45202  
(513) 579-1414

*Attorneys for Petitioner*

\*Counsel of Record

<sup>46</sup> In addition to different obligors and underlying real estate securing the mortgages, the Tax Court found that the transaction “clearly changed the flow of economic benefits” to Cottage as collections on the loans were not equal, and the participations that Cottage ended up with were a different type of ownership than the mortgages it originally owned. (P.A. 30a, 37a).

### APPENDIX

#### Internal Revenue Code of 1954 (26 U.S.C.)

##### § 165 *Losses*

(a) *General rule.* There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

##### § 1001 *Determination of Amount of and Recognition of Gain or Loss.*

(a) *Computation of Gain or Loss.* The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.* The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized –

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and

(2) there shall be taken into account any amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) *Recognition of Gain or Loss.* Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

§ 1031 *Exchange of Property Held for Productive Use or Investment.*

(a) *Nonrecognition of Gain or Loss from Exchanges Solely in Kind.* No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

**Treasury Regulations on Income Tax (26 C.F.R.)**

§ 1.165-1 (b)

(b) *Nature of loss allowable.* To be allowed as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and § 1.165-11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

§ 1.165-1 (d)

(d) *Year of deduction.* (1) A loss shall be allowed as a deduction under section 165(a) only for the taxable year in which the loss is sustained. For this purpose, a loss shall be treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year. . . . [Remaining portions, which are not pertinent to sales or exchanges, are omitted]

§ 1.1001-1 *Computation of gain or loss.*

(a) *General rule.* Except as otherwise provided in Subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value. The general method of computing such gain or loss is prescribed by section 1001(a) through (d) which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 1011 and the regulations thereunder (*i.e.*, the cost or other allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the adjusted basis has been restored to the

taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained to the extent of the difference between such adjusted basis and the amount realized. The basis may be different depending upon whether gain or loss is being computed. For example, see section 1015(a) and the regulations thereunder. Section 1001(e) and paragraph (f) of this section prescribe the method of computing gain or loss upon the sale or other disposition of a term interest in property the adjusted basis (or a portion) of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent) or section 1015 (relating to the basis of property acquired by gift or by transfer in trust).

**Treas. Reg. § 1.1002-1.**

(a) *General rule.* The general rule with respect to gain or loss realized upon the sale or exchange of property as determined under section 1001 is that the entire amount of such gain or loss is recognized except in cases where specific provisions of subtitle A of the Code provide otherwise.

(b) *Strict construction of exceptions from general rule.* The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the

specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

(c) *Certain exceptions to general rule.* Exceptions to the general rule are made, for example, by sections 351(a), 354, 361(a), 371(a)(1), 371(b)(1), 721, 1031, 1035 and 1036. These sections describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

(d) *Exchange.* Ordinarily, to constitute an exchange, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.

## PRIOR REVENUE ACTS

### Revenue Act of 1918

#### BASIS FOR DETERMINING GAIN OR LOSS.

Sec. 202. (b) When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or other property exchanged.

### Revenue Act of 1921.

#### BASIS FOR DETERMINING GAIN OR LOSS.

Sec. 202. (c) For the purposes of this title, on a exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized -

(1) When any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use;

## Act of March 4, 1923.

### FOR DETERMINING GAIN OR LOSS.

#### Sec. 202. (c) . . .

(1) When any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale, and in the case of property held for investment not including stock, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidence of indebtedness or interest), is exchanged for property of a like kind or use.

. . .

### Revenue Act of 1924.

#### DETERMINATION OF AMOUNT OF GAIN OR LOSS.

Sec. 202. (a) Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in subdivision (a) or (b) of section 204, and the loss shall be the excess of such basis over the amount realized.

(b) In computing the amount of gain or loss under subdivision (a) proper adjustment shall be made for (1) any expenditure properly chargeable to capital account, and (2) any item of loss, exhaustion, wear and tear, obsolescence, amortization, or depletion, previously allowed with respect to such property.

(c) The amount realized from the sale or other disposition of property shall be the sum of any money

received plus the fair market value of the property (other than money) received.

(d) In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 203.

(e) Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

#### RECOGNITION OF GAIN OR LOSS FROM SALES AND EXCHANGES.

Sec. 203. (a) Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 202, shall be recognized, except as hereinafter provided in this section.

(b) (1) No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment, or if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

#### Revenue Act of 1934.

#### Sec. 112(a) RECOGNITION OF GAIN OR LOSS.

*General rule.* – Upon the sale or exchange of property the entire amount of gain or loss, determined under Section 111, shall be recognized, except as hereinafter provided in this section.

#### (b) *Exchanges solely in Kind.* –

(1) Property held for productive use or investment – No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

#### REGULATIONS

Treas. Reg. § 45 (1920 ed.)

*Art. 1563. Exchanges of property.* – Gain or loss arising from the acquisition and subsequent disposition of property is realized when as the result of a transaction between the owner and another person the property is converted into cash or into property (a) that is essentially different from the property disposed of and (b) that has a market value. In other words, both (a) a change in substance and not merely in form, and (b) a change into the

equivalent of cash, are required to complete or close a transaction from which income may be realized. By way of illustration, if a man owning ten shares of listed stock exchanges his stock certificate for a voting trust certificate, no income is realized, because the conversion is merely in form; or if he exchanges his stock for stock in a small, closely held corporation, no income is realized if the new stock has no market value, although the conversion is more than formal; but if he exchanges his stock for a Liberty bond, income may be realized, because the conversion is into independent property having a market value. "Market value" is the price at which a seller willing to sell at a fair price and a buyer willing to buy at a fair price, both having reasonable knowledge of the facts, will trade. Property received in exchange for other property has no "fair market value" for the purpose of determining gain or loss resulting from such exchange when, owing to the condition of the market, there can be no reasonable expectation that the owner of the property, though wishing to sell and any person wishing to buy will agree upon a price at which to trade unless one or the other is under some peculiar compulsion. It does not follow that property has no "fair market value" merely because there is no price therefor established by public sales or sales in the way of ordinary business. The property received in exchange may be real estate, personal property, or a chose in action. Where the owner of a bond exercises the right, provided for in the bond, of converting the bond into stock in the obligor corporation, such transaction does not result in a realization of profit or loss, the transaction not being closed for purposes of income taxation until such stock is sold.

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